THE IMPACT OF PUBLIC POLICY ON THE BANKING SYSTEM IN NIGERIA

Martin Brownbridge

Summary

The banking system in Nigeria has undergone radical changes during the 35 years since independence. Banking developed from an industry which in 1960 was dominated by a small number of foreign owned banks into one in which public sector ownership predominated in the 1970s and 1980s and in which Nigerian private investors have played an increasingly important role since the mid 1980s. Extensive government intervention characterised financial sector policies, beginning in the 1960s and intensifying in the 1970s, the objective of which was to influence resource allocation and promote indigenisation. Since 1987 financial sector reforms have been implemented, encompassing elements of liberalisation and measures to enhance prudential regulation and tackle bank distress.

The paper concentrates on the commercial and merchant banks, which together accounted for 85 per cent of the total assets of the main financial institutions in Nigeria, excluding those held by the Central Bank of Nigeria (CBN), in 1993. It explores explores two related issues. First, that government controls on financial markets, public ownership of banks and the neglect of prudential regulation, had detrimental effects on the banking system, especially in terms of the quality of banks' loan portfolios, efficiency and competition. Second, that the efficacy of financial liberalisation and other financial sector reforms to enhance the efficiency of intermediation in banking markets has been limited, in part because of the legacy of pre-reform intervention in banking markets, which left large sections of the banking industry in financial distress, but also because some of the reforms were inappropriately sequenced and others were not implemented in a consistent manner.

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THE IMPACT OF PUBLIC POLICY ON THE BANKING SYSTEM IN NIGERIA[1]

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1 INTRODUCTION

The banking system in Nigeria has undergone radical changes during the 35 years since independence. Banking developed from an industry which in 1960 was dominated by a small number of foreign owned banks into one in which public sector ownership predominated in the 1970s and 1980s and in which Nigerian private investors have played an increasingly important role since the mid 1980s. Government policies had a major influence on developments in the banking industry. Extensive government intervention characterised financial sector policies, beginning in the 1960s and intensifying in the 1970s, the objective of which was to influence resource allocation and promote indigenisation. Since 1987 financial sector reforms have been implemented, encompassing elements of liberalisation and measures to enhance prudential regulation and tackle bank distress.

This paper explores the impact of government policies on the development of banking in Nigeria in the period since independence. We examine how banks were affected by public ownership and policies of financial repression, the reasons behind the growth of local private sector banks, the causes of the financial distress in the banking industry and the efficacy of the financial reforms undertaken since 1987. We aim to explore two related issues. First, that government controls on financial markets, public ownership of banks and the neglect of prudential regulation, as opposed to allocative regulation, had detrimental effects on the banking system, especially in terms of the quality of banks' loan portfolios, efficiency and competition. Second, that the efficacy of financial liberalisation and other financial sector reforms to enhance the efficiency of intermediation in banking markets has been limited, in part because of the legacy of pre-reform intervention in banking markets, which left large sections of the banking industry in financial distress, but also because some of the reforms were inappropriately sequenced and others were not implemented in a consistent manner.

The paper concentrates on the commercial and merchant banks. Although other financial institutions have been set up in Nigeria, including development finance institutions (DFIs), insurance companies and more recently a plethora of finance houses, hire purchase companies and mortgage companies, banking dominates the financial markets. As shown in Table 1, the commercial and merchant banks together accounted for 85 per cent of the total assets of the

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main financial institutions in Nigeria, excluding those held by the Central Bank of Nigeria (CBN), in 1993.

The paper is organised as follows. Section 2 outlines the main elements and objectives of government allocative controls on banking policies in the post independence period. The participation of the Federal and State Governments in the ownership of banks and its consequences for the financial performance of these banks is examined in Section 3. Section 4 analyses the reasons behind the growth of the local private sector banks and the fragility that has recently emerged in this sector. The effectiveness of the system of prudential regulation and supervision is examined in Section 5. This section also discusses the reforms to the prudential system and policies to address bank distress which have been implemented since the late 1980s. The impact of financial liberalisation in terms of enhancing efficiency in banking markets is discussed in Section 6. Section 7 concludes.

The rest of this introduction provides a brief sketch of the historical development of the banking industry in Nigeria.

The three largest banks currently operating in Nigeria (sometimes referred to as first generation banks) have their origins in the colonial period. The British Bank for West Africa (now called First Bank) was incorporated in 1894, the Colonial Bank, later acquired by Barclays and now known as Union Bank, began operations in 1917, and the British and French Bank, the precursor of the United Bank for Africa, started in 1949. All three were originally wholly foreign owned but the Federal Government purchased majority share holdings in the mid 1970s. These banks encountered little serious competition during the colonial period. Although a number of banks were set up by Nigerian investors during the so called free banking era (prior to the enactment of the first banking legislation in 1952) most failed within a few years of opening.

Beginning around the time of independence, a second generation of banks were set up in Nigeria. The first group of second generation banks were also mainly foreign owned. They included the Banque Internationale Pour L'Afrique Occidental (BIAO), now called Afribank, which is the fourth largest bank in Nigeria. This was followed in the 1970s by the establishment of commercial banks by the state governments in Nigeria and by the entry of a number of merchant banks, mostly as joint ventures between foreign investors and the Federal Government and/or private investors. The Federal Government took controlling shares in all of the foreign owned banks in the mid 1970s, and enacted an indigenisation decree in 1977 which limited foreign participation in banks to a maximum 40 per cent of equity. By 1980 there were 20 commercial banks and six merchant banks in operation, in all but a few of which the Federal Government or state governments were the majority shareholders.

A third generation of banks emerged during the 1980s. Some of these banks were set up by state governments but the majority were started by Nigerian private investors. The growth of the local private banks was very rapid after 1986, particularly in the merchant banking sector. By 1992 there were 66 commercial banks and 54 merchant banks in operation in Nigeria. Tables 2 and 3 chart the growth of banks and their ownership structure since 1960. Despite the growth of new entrants however the three largest banks have retained their dominance of banking markets, accounting for 48 per cent of the total deposits of the commercial banks in 1994, while Afribank accounts for a further 7 per cent.

Since the late 1980s the banking industry has been afflicted by widespread financial fragility: 57 banks, almost half the total number of banks in operation, were regarded as distressed or potentially distressed by the regulatory authorities in 1995. Most of the distressed banks were owned by state governments or the local private sector.

2 BANKING SECTOR POLICIES IN NIGERIA

The banking sector has been subject to extensive regulation by the CBN as well as direct participation by the Federal Government and state governments during the post independence period. Economic nationalism and developmental aspirations were important motivations for interventionist policies. The character of these policies was that of financial repression, in that controls depressed interest rates and channelled resources away from areas where private rates of return would have been maximised. The allocative controls have been liberalised to some extent since 1986, although controls over key areas remain in force. This section outlines the efforts made by the CBN to influence resource allocation in the banking industry through the use of administrative controls: policies pertaining to public ownership of banks are discussed in Section 3.

The domination of banking by expatriate banks during the colonial period provoked considerable resentment among Nigerians, including businessmen and politicians. The expatriate banks were perceived as acting solely in the interests of their foreign owners rather than of Nigerians and of the Nigerian economy. In particular they were accused of discriminating against indigenous businesses in the allocation of loans, and failing to finance the developmental needs of the country, instead concentrating on the provision of short term trade related finance to foreign companies. Consequently government objectives following independence included securing greater local control over the banking system, and ensuring improved access to credit for indigenous businesses and priority sectors (Nwankwo 1980).

During the 1960s the CBN was given extensive powers to regulate the quantity, cost and direction of bank credit. These powers were used to further monetary control (a priority throughout most of the post independence period because of inflationary pressures in the economy) and the objectives of influencing resource allocation and indigenisation. The main instruments of monetary policy were aggregate ceilings on the expansion of banks' credit, while sectoral credit guidelines and interest rate controls were used to influence the direction and cost of credit. From 1969 onwards the controls over the banking system were set out in annual monetary policy circulars issued by the CBN.

The 1969 Banking Decree empowered the CBN to set the structure of bank interest rates, specifically minimum deposit rates and minimum and maximum lending rates, with priority sectors (e.g. manufacturing, agriculture, etc.) subject to preferential lending rates. The controls held nominal deposit and lending rates below the rate of inflation in most years during the 1970s and 1980s (see Table 4).

The direction of bank credit was influenced through guidelines issued by the CBN stipulating the minimum and maximum percentage shares of a bank's total loans to be allocated to particular sectors and to indigenous businesses. Additional guidelines prescribed minimum levels for lending to small scale enterprises and loans extended in rural areas. The merchant banks were also subject to guidelines stipulating the term structure of their loan portfolio: these were designed to ensure that they undertook medium and long term lending (Soyibo and Adekanye 1992). Banks which failed to comply with the prescribed limits were subject to penalties or had to transfer to the DFIs or CBN any shortfall in lending to priority sectors, a course of action which banks often preferred rather than extending loans to borrowers perceived as uncreditworthy or too costly to service (Ndekwu 1994: 150). The effectiveness of the guidelines in channelling credit to the priority sectors was limited: Bank lending frequently fell short of the minimum prescribed for the preferred sectors, particularly to agriculture (Oyewole 1994: 97-99).[2] Moreover the sectoral definitions were not always clear, which together with the fungibility of credit, further reduced the impact of the guidelines in directing credit towards the priority sectors.

A rural banking programme was initiated in 1977 under which the commercial banks were provided with targets to establish specified numbers of branches in the rural areas over the following decade. The objectives were to attract cash held in the rural areas into the banking system so as to increase the effectiveness of monetary policy, extend rural credit facilities and spread the banking habit (Adegbite 1994: 41). The banks were expected to set up over 750 rural branches under the programme.

[2] Oyewole (1994: 98) presents data showing that during the 11 years from 1975 to 1985, the aggregate lending of the commercial banks to agriculture met the prescribed sectoral target in only one year, as did that of the merchant banks. The average share of loans to agriculture in total commercial bank lending was 6.7 per cent in this period, compared with an average for the minimum prescribed share of 7.8 per cent: the comparable figures for merchant banks were 3.6 per cent and 5.1 per cent respectively.

The sharp fall in Nigeria's oil revenues in the first half of the 1980s precipitated a severe economic crisis which exposed the adverse consequences of the wide ranging regime of controls imposed on the economy, including controls on the financial sector. In response the Federal Government embarked on a major shift in economic strategy in 1986 with the adoption of a structural adjustment programme (SAP). As part of the switch towards more market oriented policies, some of the allocative controls over financial markets, such as those over interest rates, have been liberalised, albeit in an inconsistent manner. Financial liberalisation is discussed in Section 6.

3 THE PERFORMANCE OF PUBLIC SECTOR BANKS IN NIGERIA

3.1 BANKS WITH FEDERAL GOVERNMENT OWNERSHIP

Public sector ownership has been a dominant feature of the banking system in Nigeria since the mid 1970s, although its importance has diminished with the growth of the local private sector since the mid 1980s and the sale of Federal Government equity to the private sector in 1992/93. During the 1970s the Federal Government acquired controlling equity stakes in the first and second generation foreign banks in Nigeria. Most of these were subsequently operated as joint ventures with the foreign shareholders which retained minority stakes, which included Standard Chartered, Barclays (which subsequently disinvested), Banque Nationale de Paris, BIAO, Bank of America and Bank of India. The Federal Government had major share holdings in eight commercial and five merchant banks, nine of which were joint ventures with foreign investors: it also had a minor stake in one other merchant bank. The banks in which the Federal Government had a share holding included the four largest commercial banks and three of the five largest merchant banks ranked according to total assets in Nigeria.[3] As part of the privatisation programme, the Federal Government sold most of its equity holdings in seven commercial banks and two merchant banks to Nigerian private investors in 1992/93, although it threatened to re-establish controlling stakes in the four largest commercial banks in 1995.

The motivation for Federal Government equity participation in banking was the desire to control strategic industries and to further the policy of indigenisation. The Federal Government's explicit policy towards the banks in which it held equity was to appoint board members, including the chairman, and to set out the broad outlines of policy while leaving day to day operational decisions to the banks' management, which initially was largely controlled by the foreign shareholders (Nwankwo 1980: 74-77). Federal Government ownership of banks therefore reinforced the controls employed by the CBN to influence

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[3] The combined assets of the 14 banks with Federal Government participation accounted for 51 per cent of the industry's total assets in 1992 (NDIC 1992: 47).

resource allocation by the banking industry, most notably in three different aspects of banking policy.

First, the management of the Federal Government banks was almost entirely indigenised by the end of the 1980s: only a few specialised posts were still filled by expatriates. Second, these banks were in the forefront of the programme to establish branches in the rural areas. Third, credit policies were influenced by 'policy lending', i.e. extending credit to the public sector, to locally owned businesses and to the priority 'productive sectors' as set out in the credit guidelines. The second and third of these developments adversely affected the banks' financial performance. Most of the rural branches established under the rural banking programme have not been profitable mainly because the volume of business generated in the rural areas has been insufficient to cover overheads. The banks accumulated substantial volumes of non performing debts as a result of lending to the public sector or as a result of lending in line with credit guidelines. The accumulated non performing loans of the four largest commercial banks amounted to an average of 40 per cent of each banks' total loan portfolio in 1994 (Agusto and Co, Appendix 1, p 24).

The financial performance of the Federal Government banks during the 1970s and 1980s does not appear to have been very good while the quality and efficiency of their services were poor. The four largest commercial banks all recorded profits during this period, although their returns on assets were low and returns to equity not especially impressive when inflation is taken into account. However assessment of their financial performance is impeded because, until 1990 when the CBN issued new prudential guidelines, they were not required to classify loans according to quality and make provisions for non performing loans, or to suspend the accrual of income from unpaid interest. Hence published accounts are likely to have overstated earnings. When the new prudential guidelines were introduced in 1990, First Bank recorded large losses as a result of having to make provisions for bad debts, while the profits of the other three major banks were sharply reduced. Their financial position would have been less secure had they not been allowed to spread the necessary provisions over a period of four years.

Nevertheless the four major Federal Government banks remained solvent and avoided the distress which afflicted many of the state government and private sector banks in Nigeria, as well as public sector banks in some other African countries.[4] These banks have avoided serious trouble for a number of reasons.

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4 Some of the smaller Federal Government banks have fared less well, especially the one commercial bank and three merchant banks in which the Federal Government has retained majority share holdings. None of these four banks has published accounts for the last four years (Business, 1995 Banking Survey, p 10). The three merchant banks (Continental, ICON, and Nigeria Merchant Bank) are reported to be distressed, with the Federal Government having appointed interim boards to manage these banks in September 1995 (Business Times, 25/9/95, p 3). The commercial bank, Nigeria-Arab

First they have employed experienced and conservative management, in part because of the influence of their foreign shareholders, but also because the Federal Government ensured that its appointees to executive positions were experienced professional bankers. Second, their portfolio management has generally been cautious: they have remained very liquid, restricting loans as a share of total assets to below 40 per cent in most years, which has reduced the adverse impact of non performing loans on their balance sheets. Their size has also ensured that their loan portfolio has been well diversified.

Third, given their international links and their historical position as the dominant banks in Nigeria, the Federal Government banks have had a base of 'prime' borrowers among the multinational companies operating in Nigeria. Fourth, competition among the large banks has been limited by the regulatory controls over, inter alia, interest rates, and, prior to 1986, by barriers to new entry into the industry. They have also had access to public sector deposits, which together with the interest rate controls, has ensured that their average cost of funds was low, which helped to offset their high overheads.

3.2 BANKS WITH STATE GOVERNMENT OWNERSHIP

The involvement of the regional and state governments in banking dates back to the 1950s. Two of the earliest indigenous banks, National Bank and African Continental Bank, had close links with politicians in the Western and Eastern Regional Governments. The regional governments acquired equity in these banks when they got into financial difficulties in the mid 1950s and eventually became the majority shareholders. In 1959 the Bank of the North was established by the Northern Regional Government in partnership with Lebanese investors. Another indigenous bank (Agbonmagbe Bank, since renamed Wema Bank) was taken over in 1969. During the 1970s the state governments, which had replaced the regional governments in the late 1960s, began setting up their own banks: by 1980 there were ten banks in which state governments held equity and this number had risen to 25 by 1989 (see Table 2). The primary motivation of the state governments in setting up these banks was to access funds for development projects in the states and to expand lending to indigenous businesses (Nwankwo 1980: 74).

Most of the state government banks are joint ventures with local private investors: state governments hold majority share holdings in 11 of these banks and minority share holdings in the other 14. The state government banks accounted for 20.5 per cent of total commercial bank assets in 1994. Most of these banks are relatively small: only two (Wema Bank and Bank of the North) are among the largest ten banks in terms of lending.

Bank, began a restructuring programme in 1993 but is reported to require recapitalisation of N350 million ($4 million), (Thisday, 5/10/95, p 10).

The financial performance of most of the state government banks has been very poor. Ten distressed state government banks were taken over by the CBN during 1992-95, and it is very likely that several more state government banks are among the more than 50 banks regarded as distressed by the regulatory authorities (with the exception of those taken over by the CBN the distressed banks have not been officially named).[5] In addition to the banks taken over by the CBN, a further three state government banks have not published annual reports for at least two years.[6] The banks which appear to have remained solvent are mainly those in which state government participation has been limited to minority share holdings.

The scale of the financial difficulties facing the state government banks is evident from data published by the Nigeria Deposit Insurance Corporation (NDIC). The state government banks as a whole made losses amounting to N0.7 billion and N1.2 billion in 1993 and 1994 respectively (the latter figure was equivalent to 75 per cent of their total paid up capital). Twelve state government banks recorded a liquidity ratio, averaged throughout 1994, which was less than the statutory minimum of 30 per cent of their deposits. Sixty per cent of the total loans and advances of the state government banks were classified (i.e. non performing) in 1994. As a consequence of their non performing loans the capital and reserves of the state government banks had been eroded to an aggregate of negative N8.4 billion (approximately $100 million) in 1994. A total of N10.2 billion was required to restore capital adequacy to the statutory minimum levels (NDIC 1994: 8-16).

The poor financial performance of the state government banks is not just a recent development, although it has become more evident during the 1990s because of the imposition of the stricter prudential regulations in relation to loan classification and capital adequacy, and the tightening liquidity position. Ibe (1992) assessed the performance of banks in Nigeria during the first half of the 1980s in terms of their ownership. The 14 state government banks in his survey were only marginally profitable: rates of return (after tax profits) to shareholders' funds averaged only 3 per cent compared to 24 per cent for the non state government banks.[7] The 1985 Annual Report of the CBN noted that management and accounting systems were unsatisfactory in state government banks and that bad debts had depleted capital (CBN 1985: 118). A World Bank mission in 1988 reported that at least

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5 The first six state government banks taken over by the CBN were subsequently acquired by it for a nominal sum of N1 each because their owners would not provide the finance needed to recapitalise them. The CBN has now offered these banks for sale.

6 The Agusto and Co (1995) survey of the banking industry excluded 50 banks considered distressed or potentially distressed by the CBN plus an additional 14 which had not published annual reports and accounts within the statutory period of four months from their accounting dates. This left 66 solvent banks with up to date reports and accounts, of which only five banks (Eko International, Inland, Trade, Trans International and Wema) had state government participation.

7 It is likely that recorded profits would have been even lower had these banks been forced to make adequate provisions for non performing loans and suspend accruing income on unpaid interest.

eight banks were then insolvent, a figure which would have been higher had banks used proper accounting practises (Oluranti 1991: 59).

The financial problems afflicting the state government banks are attributable to a number of factors. The quality of their management has been very poor because of political interference in the appointment of directors, managers and staff. Appointments were determined by political patronage rather than merit while boardroom disputes and the insecure tenure of board and management due to frequent changes in the political control of state governments further undermined the quality of management (Ebhodaghe 1994: 17). Earnings have been eroded by high operating expenses: the 14 state government banks in the survey by Ibe incurred operating expenses amounting to 76 per cent of net earnings compared to 49 per cent for other banks (Ibe 1992: 250). Many of the banks were set up without adequate capital and were unable to meet the minimum capital requirements when these were raised in the late 1980s and early 1990s.[8]

The most important cause of the financial distress of this sector has been the accumulation of bad debts, including those extended as a result of political interference to their own governments and to politically influential borrowers. As noted above, 60 per cent of their total loan portfolio was non performing in 1994. In June 1991 the non performing loans owed by the state governments to state government and distressed banks[9] amounted to N795 million: this was equivalent to 16 per cent of the total classified loans of the state government banks in 1991 (Ebhodaghe 1992a: 12; NDIC 1992: 17).[10] The fiscal crises afflicting the state governments since the early 1980s has undermined their ability to service their debts and to recapitalise their own banks. Frequent changes of government at the state level have exacerbated the problem of non performing debt, as incoming governments have not regarded the servicing of loans contracted by previous incumbents as a priority.

4 THE GROWTH OF THE LOCAL PRIVATE SECTOR BANKS

Since the mid 1980s the locally owned private sector banks (henceforth local banks) have grown rapidly, and now account for a substantial share of commercial and especially merchant banking markets.[11] Local banks are defined here as those banks which were set up with local private sector investors as the major shareholders, rather than by foreign investors

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8 Six state government banks had not met the minimum statutory requirement of N50 million for paid up share capital in 1992 (NDIC 1992: 20-22).

9 All except one of the then distressed banks were owned by state governments.

10 Of the outstanding credit extended to the state governments by their own banks and the one other distressed bank, 94 per cent was non performing in June 1991. Non performing debts owed to Federal Government banks by state governments were even larger, amounting to N1.3 billion (Ebhodaghe 1992a: 12).

11 In 1992 the locally owned private sector banks held 25.7 per cent of the total assets of commercial banks and 68.2 per cent of the total assets of merchant banks (NDIC 1992: 35-6).

or the public sector.[12] In 1992 there were 33 local commercial banks and 48 local merchant banks in operation.[13] Foreign investors held minority stakes in seven of the local commercial banks and seven of the merchant banks: the rest were wholly owned by Nigerian private investors. Most of these banks were set up between 1986, when financial markets were first liberalised, and 1991, when the CBN suspended issuing new licenses in response to the emerging signs of distress in the industry. The local banks are very heterogeneous: whereas a few banks have grown into major market participants, establishing a reputation for providing efficient professional services and attracting a blue chip corporate clientele, many others have been associated with fraud and mismanagement and have experienced severe financial distress in the 1990s. This section examines the reasons for the growth of this sector, the salient characteristics of these banks, and the causes of the distress which emerged in the early 1990s.

The first local banks were established in Nigeria during the late 1920s and 1930s at a time when banking was effectively unregulated and entry unrestricted. The banks were set up by local businessmen, many of whom had encountered difficulties in obtaining credit from the expatriate banks. After the end of the second world war there was an indigenous banking boom with 185 so called 'mushroom banks' registered between 1947 and 1952, although most did not actually commence operations. Most of the banks that did start operating collapsed within a few years due to a combination of mismanagement, insider lending and inadequate capitalisation. Only four of the banks set up by local investors during the colonial period survived until independence in 1960, all with the aid of substantial financial support from the regional governments, whose explicit policy was to support the efforts of indigenous banks to finance local businesses. These banks were also used to finance political activity and to channel loans to party supporters as well as the banks' directors. The introduction of the 1952 Banking Ordinance, which for the first time in Nigeria imposed entry conditions for banks such as minimum capital requirements, and the loss of public confidence induced by the failure of local banks, brought the indigenous banking boom to an end by the mid 1950s (Nwankwo 1980: 45-53).

For a period of almost 25 years until the mid 1970s, few new banks were set up by Nigerian private investors: new investment in banking was largely initiated by foreign banks and the public sector. The Nigerian private sector began to return to banking in the mid 1970s, initially in partnership with foreign investors.[14] From the mid 1970s until 1986, 13 private sector banks were set up in which Nigerian investors were majority shareholders: in ten of these banks foreign investors, mostly established foreign banks such as Société Générale,

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12 This definition excludes the recently privatised Federal Government banks as well as those state government banks in which the private sector holds shares.

13 These figures exclude the four local banks which had been taken over by the CBN.

14 Nigerian private investors also participated in some of the state government banks.

Citibank and Grindlays, held minority stakes (the 1977 indigenisation decree barred foreigners from holding majority stakes). The 1970s were a period in which investment opportunities in the Nigerian economy expanded rapidly due to the oil boom, and in which a substantial Nigerian capitalist class emerged. The fact that Nigerian private investors entering banking, without foreign partners, were so few up until the mid 1980s is therefore rather surprising. It is probably at least partly attributable to restrictive licensing policies adopted by the authorities.

Following the introduction of the SAP in 1986 local banks were set up in much larger numbers. During 1987-92, approximately 27 local commercial banks and 42 local merchant banks were established. Not only did the rate of new entry accelerate sharply in this period, but there was also a qualitative shift in the composition of ownership, with foreign partnership limited to only four of these banks. The rest were wholly owned by the Nigerian private sector. The late 1980s and early 1990s also saw the rapid growth in the number of finance houses, some of which were affiliated to banks. In 1992, 666 finance houses were operating, but many subsequently collapsed.

The growth in the local banks can be attributed to several factors. First, the inefficiencies of the public sector banks provided opportunities for new entrants to target corporate and high income urban customers. The local banks were able to attract these customers by offering higher interest rates on deposits following interest rate deregulation in 1987. A few of the local banks have attracted customers by providing more efficient services, such as much faster loan appraisals, and innovative products.

Second, many of the banks were set up primarily so that their owners could obtain foreign exchange which could be resold at a premium. The foreign exchange market was liberalised in 1986, with the introduction of a foreign exchange auction system.[15] Although the specific mechanism changed several times, the essence of the system involved the CBN auctioning the available foreign exchange to the banks: only the banks were authorised to bid for foreign exchange, which were then expected to supply their customers. To ensure that the available foreign exchange was distributed widely among the banks, ceilings were placed on the amount which each bank could bid for. The auction system did not eliminate the parallel market, in which a premium over the auction rate could be obtained from the sale of foreign exchange. This premium averaged 33 per cent during 1987-90 (Olisadebe 1991: 178). Consequently those with access to the foreign exchange auction could make substantial profits by reselling the foreign exchange at parallel market rates. In 1989 bureaux de change began operating, in which exchange rates approximated those on the parallel market: this provided another outlet for the banks to resell foreign exchange purchased from the auction.

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15 Olisadebe (1991) provides an account of the foreign exchange auction systems used in Nigeria.

The restriction of access to the auction to banks, combined with the allocation system which meant that even small banks were able to obtain foreign exchange, provided a powerful incentive for investors to establish banks, even if they had no interest in conducting more conventional banking business.

Third, some of the banks have been set up in order to channel customer deposits into the business ventures of their owners and to conduct other types of fraud. How extensive this has been is impossible to estimate as evidence of frauds of this nature usually only comes to light when banks are liquidated. So far only four local banks have been liquidated although many more are distressed. Each of the four liquidated banks was used for extensive insider lending, suggesting that abuses of this nature may be widespread.

Fourth, the criteria for granting banking licenses appear to have been relaxed and politicised in the second half of the 1980s.[16] The Federal Ministry of Finance had the authority to grant licenses with the Presidency and Federal Executive Council also involved in reviewing applications. Political influence was used to obtain licenses for applicants, many of whom had no banking experience, but did have links to the military. Moreover the minimum capital requirements were eroded by inflation during the 1980s. By 1987 it was possible to establish a commercial bank with paid up capital equivalent to less than $350,000 and a merchant bank with less than $0.5 million (see Table 5).

The local banks are urban based and have small branch networks. Most have avoided traditional retail banking, instead concentrating on foreign exchange dealing, foreign trade financing, the financing of local businesses, and various forms of off balance sheet business. A relatively small number have grown into major participants in the banking market: two are among the largest ten banks ranked according to deposits, while several more have gained an important share of the lucrative market for corporate finance. Many others, especially the merchant banks, have remained fringe players in the banking markets: some are little more than single branch finance houses relying on high cost wholesale deposits for funds and lending to the least creditworthy sections of the market, including to other banks and finance houses facing liquidity shortages. Interbank funding was a major feature of the liability

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16 This is disputed by Ogunleye (1991) who argues that the growth of banks was due to increased interest in banking from investors rather than a liberalisation of entry requirements: he points to the fact that 70 per cent of license applications during the 1980s were not approved and that the approval rate (licenses approved as a share of total applications) actually declined after 1985 to support this. What is not in dispute is that the number of license applications increased rapidly during the 1980s - the figures given by Ogunleye (1991: 44) indicate that there were 56 applications during 1980-85 compared to 99 during 1986-88, with 20 and 26 approvals in these two periods respectively (these figures include applications from state governments as well as private investors). The data given by Ogunleye do not extend beyond 1988 but, given the number of new banks set up, at least another 50-60 licenses must have been approved during 1989-91. It is quite likely that the quality of applicants declined as the numbers increased, and there is certainly a widespread perception in the industry that licenses were given to applicants without adequate consideration for their expertise in banking.

structure of the local merchant banks, accounting for 44 per cent of the merchant banks' total local currency deposits in 1990/91, although its importance has diminished sharply since 1992 for reasons discussed below (Augusto and Co 1995: 17). There is a serious shortage of qualified and experienced managers in the local bank sector, and boardroom disputes, caused in part by the practise of fronting, whereby shareholders appoint nominees to circumvent restrictions in the banking laws on equity concentration, are commonplace (Ebhodaghe 1992b).

Most of the local banks were able to generate high profits during the second half of the 1980s: the cost of deposits was generally low and foreign exchange dealing was lucrative. A group of around ten local private sector banks has continued to generate reasonable profits during the 1990s, despite the problems afflicting other banks in the industry, and appears (although balance sheet data can be misleading) to have avoided serious problems with bad debt.[17] However many other local banks have run into serious difficulties. Four local banks were liquidated by the CBN in 1994, and a further 13 distressed local banks were taken over by the CBN in September 1995. Two other banks had their licenses suspended for persistent infractions of the banking laws in 1994 (one of which is still suspended). The merchant banks have been hardest hit by the distress in this sector: 12 of the 17 local banks liquidated or taken over by the CBN are merchant banks.[18]

The financial distress of the local banks is attributable to the combination of bad debts, due in particular to insider lending, and a tightening of liquidity in the banking system.

Although data on the loan quality of the distressed local banks is not publicly available, a crude estimate can be obtained by subtracting data pertaining to the 25 state government banks from the aggregate data pertaining to all 45 banks considered distressed at the end of 1994, which are published by the NDIC (NDIC 1994: 9 and 43).[19] This estimate suggests that the non performing loans of the distressed local banks amounted to around N13.5 billion

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17 Only ten local banks (seven commercial and three merchant) recorded rates of return to capital which were equivalent to, or higher than, the rate of inflation during 1992-94. While many other banks recorded nominal profits, their rates of return to capital were below the rate of inflation (data on rates of return from Banking and Finance Digest, 3 (9): 24-25, 1995).

18 Financial distress almost certainly involves many more local banks than those which have been liquidated or taken over so far. An additional seven local banks have not published accounts for at least two years. Moreover there were a reported 57 banks (both public and private) regarded by the authorities as distressed in March 1995: assuming that at most 20-25 of these are Federal or state government banks, the remaining 32-37 must be local banks. As such financial distress afflicted nearly half the 81 local banks operating in 1995.

19 This is not a precise estimate because not all the state government banks are distressed while there are a few Federal Government banks in distress. Moreover the total number of distressed banks has risen since 1994.

or 74 per cent of their total loan portfolio.[20] Most of the non performing loans were unsecured and have been unrecoverable.

Bad debts arose as a consequence of the difficult macroeconomic environment - increased interest rates, reduction of protection and subsidies, and economic stagnation undermined the ability of borrowers in the real sector to service their loans - and mismanagement and fraud in the banks. Prudent lending practises were not followed because boards of directors did not provide honest and effective leadership, often being more concerned with securing credit facilities for themselves, managers were inexperienced and often lacked independence from major shareholders, while credit policies and internal controls were poor or non existent (Mamman and Oluyemi 1994).

Insider lending is a major cause of the bad debt: insider loans accounted for 65 per cent of the total loans of the four local banks liquidated in 1994, of which less than 1 per cent has been recovered by the liquidator (NDIC 1994: 48). In addition it is likely that interbank market defaults have contributed to the fragility in this sector: some of the distressed banks relied heavily on interbank deposits and their inability to repay their liabilities would have spread distress to other banks.[21] The collapse of large numbers of finance companies in 1993, to which some of the local banks were exposed, also exacerbated distress among the local banks (Augusto and Co 1995: 40).

The second aspect of the distress among the local private sector banks was their worsening liquidity position. This was caused in part by their own internal problems - the deterioration in loan quality and therefore earnings - and partly by exogenous developments. During the second half of the 1980s the local banks were able to access funds from customers wishing to purchase foreign exchange, from depositors attracted by competitive deposit rates, and from the interbank market. However as the number of banks expanded, competition for deposits increased while the authorities intensified their efforts to reduce bank liquidity because of mounting inflation. In 1989 the Federal Government ordered that all public sector deposits should be transferred from the commercial and merchant banks to the CBN. The CBN and NDIC had subsequently to provide N2.3 billion in loans to banks unable to meet their inter-bank obligations (Ebhodaghe 1991: 13).

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20 Another indicator of the asset quality of the local banks can be obtained from aggregate data pertaining to the merchant banks, approximately 68 per cent of the assets of which are held by local banks (NDIC 1992: 36). In 1994 64 per cent of the merchants banks' total loans and advances were classified as non performing (NDIC 1994: 9). As these figures cover all merchant banks, both non distressed and distressed, the non performing loans of the distressed merchant banks are an even larger percentage of their total lending.

21 Two of the liquidated merchant banks had respectively raised 68 per cent and 84 per cent of their total deposit liabilities from Interbank deposits (Manu 1994: 20).

This was followed in the early 1990s by the issuance of stabilisation securities by the CBN to those banks with excess liquidity. The consequence was a reduction in the aggregate liquidity of the banking system which contributed to a sharp rise in interest rates on interbank deposits. Interbank rates rose to 115 per cent in December 1992. Moreover the availability of funds on the interbank market diminished sharply when some banks began to default on their interbank market obligations in 1992/93 and when the finance companies began to collapse in 1993.[22] As the scale of the fragility in the industry became apparent depositors withdrew funds from banks suspected of being distressed into those perceived as being more secure. The difficulties involved in deposit mobilisation combined with the non servicing of a large share of their loan portfolios meant that the distressed banks became increasingly illiquid and overdrawn on their accounts with the CBN.[23]

5 BANK REGULATION AND SUPERVISION

Radical reforms to the system of prudential regulation and supervision have been implemented since the late 1980s. These reforms are essential: the prudential system had proved ineffective in ensuring sound bank management, as the scale of financial distress among the state government and local banks indicates. This section examines the evolution of the system of prudential regulation in Nigeria, discusses the extent to which it contributed to distress in the banking system, and describes and assesses the reforms to prudential regulation in the 1990s.

Banking regulation was first introduced in Nigeria in the early 1950s in response to the failure of local banks. The 1952 Banking Ordinance imposed minimum requirements for paid up capital and the establishment of reserve funds. This was followed by the enactment of the 1958 Central Bank Act and the Banking Ordinance of 1959. The banking legislation was further strengthened with the enactment of the Banking Decree of 1969. This consolidated previous banking legislation, raised minimum paid up capital requirements and empowered the CBN to specify a minimum capital/deposit ratio (Nwankwo 1980: 20; Ekundayo 1994: 346). It also empowered the CBN to impose liquidity ratios and placed restrictions on loan exposure and insider lending (Oloyede 1994: 283). The legislation contained in the 1969

22 Money at call from other banks accounted for 17.2 per cent and loans and advances from other banks (excluding the CBN) for 8.6 per cent of merchant banks' total liabilities at the end of 1991: these fell to 11.8 per cent and 4.8 per cent respectively at the end of 1992 (NDIC 1992: 31). The figures given in NDIC Reports for later years are not directly comparable but it is evident that Interbank funding from loans and call deposits fell to less than 6 per cent of merchant banks' liabilities in 1993 and 1994 (NDIC 1994: 25). As a share of merchant banks' total local currency deposits, Interbank funds fell from 44 per cent in 1990/91 to 11 per cent in 1994/95 (Augusto and Co 1995: 17).

23 The vulnerability of the merchant banks to the liquidity squeeze was exacerbated by the impact of CBN regulations which stipulated that minimum shares of their loan portfolios had to be allocated to long term loans, leading to a mismatch in the maturity structure of their assets and liabilities (Umoh 1989). Their ability to mobilise deposits was also impeded because regulations prevented them accepting deposits below a specified minimum amount.

Decree established the regulatory framework for the prudential control of banking for the next 22 years until it was superseded by the 1991 Banking and Other Financial Institutions Decree (BOFID). The prudential system was ineffective in preventing mismanagement and fraud from becoming widespread in the banking system for a number of reasons. First, although the CBN was responsible for supervising banks, it lacked independence from the Federal Ministry of Finance (FMOF), especially with regard to the licensing of banks (the authority for the granting of banking licenses lay with the FMOF until this was transferred to the CBN under the 1991 BOFID), and the enforcement of sanctions when infractions of legislation were discovered. Political considerations, and a lack of technical expertise in the FMOF, impeded proper bank regulation and supervision, in particular because many of the public sector banks were expected to follow developmental objectives (Ologun 1994: 314).

Second, the primary regulatory concern of the CBN was with ensuring compliance with the allocative controls, such as the sectoral lending guidelines, rather than the prudential controls. The allocative controls weakened loan portfolio quality by diverting loans towards non viable borrowers (Jimoh 1994: 304).

Third, between the mid 1980s and 1991 the licensing procedures were too lax, allowing politically connected people to obtain licenses and operate banks despite having no obvious qualifications or relevant experience. The CBN suspended granting new licenses in 1991, but between 1986 and 1991, 84 new banks were established. The rapid growth in the number of banks overwhelmed the examining capacities of the CBN/NDIC. On site inspections were infrequent and were confined mainly to checking compliance with allocative requirements. This, combined with political constraints, allowed banks to flout the banking laws. In 1989, 27 banks failed to meet the minimum capital requirements (Alawode 1992: 107-8). It is also clear that the restrictions on unsecured insider lending were flouted. The *de facto* liberalising of licensing policy before prudential regulations and supervisory capacities were strengthened allowed undercapitalised and poorly managed banks to be set up in large numbers, and was therefore a significant contributory factor to the financial fragility which subsequently afflicted the banking industry.

Fourth, the banking legislation failed to ensure that loans were properly classified, provisions made for loan losses, and unpaid interest suspended from income (Umoh 1994: 323). This allowed banks to conceal the true state of their balance sheets.

Despite the deficiencies of prudential regulation there were very few overt bank failures between 1960 and the early 1990s.[24] It is unlikely that this was because all banks were soundly managed in this period. Although fragility in the banking system clearly worsened

[24] Four small banks closed down between 1960 and 1972.

during the 1990s, the imprudent lending policies which were the major cause of the distress probably began soon after most of the distressed banks were set up. Bank failures were probably averted in this period, despite the mounting bad loans afflicting, in particular, many of the state government banks, by a number of factors. The Federal Government appears to have had an implicit policy not to allow banks to fail, and as a result banks facing liquidity shortages because of non performing loans probably had recourse to support from the Federal budget, CBN loans, or public sector deposits, although there is little evidence to substantiate this.[25] The lack of competition due to regulatory restrictions on lending, interest rates, and new entry is also likely to have assisted some of the badly managed banks to survive, while insolvency was concealed by accounting practices which failed to reveal the true state of asset quality and income.

There was a change in the attitude of the authorities towards prudential regulation in 1988/89. The Federal Government appears to have become less willing to accommodate bank distress through public subsidies, possibly because of the need to improve macroeconomic control. Instead the emphasis changed towards imposing much stricter prudential standards, providing limited deposit insurance, and putting in place a mechanism for dealing with distressed banks.

In 1988 the NDIC was set up to insure the deposits (up to a maximum amount for a single deposit) of all licensed banks, funded by a (tax deductible) levy on the insured deposits of the banks. The NDIC was given authority to inspect banks (thus providing a second supervisory agency alongside the CBN) and also acts as the liquidator for those banks which the CBN decides to take over and close down.

The CBN introduced new capital adequacy requirements in 1990 under which the banks' minimum required capital and reserves are based on risk weighted assets, as in the Basle accords. The previous requirements, under which banks' minimum adjusted capital were computed as a percentage of loans and advances have been retained, hence banks are required to meet both ratios. The new requirements are more stringent in that they require banks to maintain higher levels of capital to support their operations (Umoh 1991). In 1991 the minimum paid up share capital for commercial banks was raised from N20 million to N50 million while that for merchant banks was raised from N12 million to N40 million (see Table 5).

The prudential guidelines issued by the CBN in 1990 directed banks to classify loans according to whether they were being serviced, to make provisions for non performing loans, to suspend unpaid interest from income, and to classify and make appropriate provisions for off balance sheet commitments. The 1969 Banking Act was replaced in 1991 by the BOFID.

25 Oluranti (1991: 59) notes that the frequency with which banks accessed CBN lender of last resort loans is not publicly available.

This strengthened the legislative powers of the CBN. It gave the CBN the sole responsibility for licensing banks and provided it with various powers to enforce the banking laws: e.g. issuing cease and desist orders, imposing penalties on bank directors and employees, and taking over the management of distressed banks. In 1994 draconian anti fraud legislation was introduced with the promulgation of the Failed Banks (Recovery of Debts) and Financial Malpractice's Decree.

Since 1992 the CBN and NDIC have taken steps to deal with bank distress. The strategy adopted involves first imposing holding actions (preventing further lending, etc.) on the distressed banks while their owners are instructed to recapitalise them, recover debts and improve their management. If they fail to do this satisfactorily the CBN then appoints interim management boards to the banks, following which it may liquidate the banks, with the NDIC reimbursing insured depositors, or acquire them for a nominal fee for possible resale to new owners. The take-over of many distressed banks was however delayed until well after the problems had been identified because of the need to secure Presidential approval (World Bank 1994: 48). In 1994 four local banks had their licenses revoked by the CBN and are currently being liquidated by the NDIC. As of late 1995 the CBN has taken control of ten state government banks and a further 13 local private sector banks, appointing interim management boards for these banks. Six of the state government banks were acquired by the CBN for a nominal sum of N1 in 1995.

The reforms outlined above have addressed many of the regulatory defects prevailing in the 1980s and put mechanisms in place for improved prudential regulation and for dealing with bank distress. Nevertheless the practical difficulties involved in both tackling the prevailing distress and in ensuring that banks are prudently managed are enormous, probably greater than anywhere else in Africa. The political and economic environment is very difficult for bankers and regulators because of the persuasiveness of corruption in both public and private sectors, excessive political interference in public administration from which the CBN and NDIC are not immune, and the severe crisis in the real sector of the economy which has created an unstable and difficult business environment for the banks' debtors.

Effective prudential supervision is likely to be impeded by the large number of banks and other financial institutions to be supervised which limits the frequency with which banks can be examined on site. Given the level of fraud in banks, the efficacy of off site supervision in revealing potential distress may also be limited. Moreover the allocative regulations imposed on banks compromise prudent management as well as encouraging bank executives to violate the spirit of CBN guidelines. The magnitude of bank distress in the banking system is especially problematic for the regulatory authorities: the net worth of the 45 distressed banks at the end of 1994 amounted to negative N19 billion (2 per cent of GDP). Restructuring and/or liquidating (and therefore reimbursing insured depositors) all the distressed banks will impose substantial financial and administrative demands on the CBN and NDIC.

6 THE IMPACT OF FINANCIAL LIBERALISATION ON BANKING

Since 1986/87 the financial system has been partly liberalised with the objectives of enhancing the efficiency of resource allocation and strengthening competition. Liberalisation has entailed the removal of some of the allocative controls and the easing of entry restrictions into banking and has undoubtedly had significant effects on banking markets. The number of banks has expanded rapidly and this has increased competition in some sections of the banking markets, mainly those serving urban and corporate customers. The growth of the local private sector banks together with the privatisation of most of the Federal Government banks has also injected a greater degree of commercial orientation into the banking system. Despite this, financial liberalisation may have had only a limited impact in terms of improving the efficiency of resource allocation in banking markets for several reasons. The deregulation of controls has been partial and inconsistent, high rates of inflation have impeded the attainment of positive real interest rates, large government deficits have absorbed a substantial share of bank finance, and mismanagement and fraud in public and private sector banks has led to extensive waste of resources.

Although the period since the mid 1980s is regarded as being one of financial liberalisation in Nigeria, important components of the control regime, in particular the sectoral credit guidelines, and those pertaining to the maturity structure of merchants banks' loans, remained in force. Interest rates were decontrolled in 1987, but the CBN has stipulated a maximum spread between deposit and lending rates since 1989, and ceilings on bank lending rates were imposed during 1991, removed in the following year and then reimposed at the beginning of 1994. Hence there were administrative constraints on the ability of banks to allocate and price credit according to market criteria. The inconsistency of interest rate policy was a further impediment to allocative efficiency and in particular was likely to have discouraged intermediation in long term financial instruments.

The decontrol of interest rates in 1987 allowed nominal deposit and lending rates to rise but the attainment of positive real rates was impeded by higher rates of inflation. The inflation rate was low in the mid 1980s when the SAP was first introduced, but increased to 38 per cent in 1988 and 41 per cent in 1989, largely because of the deficit financing discussed below. Inflation subsided during 1990-91 but accelerated again in the following year, averaging 57 per cent per annum during 1992-94. In both periods of high inflation, most nominal bank deposit and lending rates lagged significantly behind the inflation rate (see Table 4).[26] In 1994 interest rates were subject to administrative ceilings (with the result that real rates were highly negative), but even when the banks were not constrained by the ceilings they were clearly reluctant to raise deposit and lending rates to the levels necessary to ensure that real rates were positive. It is possible that they were deterred by the maximum allowable spread, which may not have been sufficient to compensate them for the increased default risk which a substantial rise in lending rates would have entailed. During the period since the introduction of the SAP, the attainment of positive real rates of interest has only been possible when inflation has been limited to at most about 20 per cent per annum.

An important premise of market oriented economic reforms is that the private sector utilises resources more efficiently than the public sector, at least in respect to the production of marketable goods. A key role for financial liberalisation therefore is to facilitate a reallocation of credit from the public to the private sectors. This did not occur in Nigeria because after 1987 the Federal Government was unable to control the size of its budget deficit and hence its domestic borrowing. During 1990-94 the overall Federal budget averaged 10.6 per cent of GDP, of which 86 per cent was financed by the domestic banking system, mainly by the CBN. To counter the inflationary effects of deficit financing, the authorities took a number of steps to absorb bank liquidity, including the issuance of stabilisation securities. The private sector was crowded out of credit markets as a consequence, although banks may also have cut back on lending to the private sector because they perceived it to be increasingly risky given the problems afflicting the real sectors of the economy. Credit to the private sector had increased as a share of total banking system credit during the late 1980s - from 47 per cent in 1986 to 63 per cent in 1991 - but then fell back sharply to 39 per cent at the end of 1994, while in real terms it was 33 per cent lower in 1993 than at the start of the SAP in 1986.[27]

As well as reallocating credit from the public to the private sector, liberalisation is intended to improve the allocation of credit. But the increasing share of loans classified as non performing, which amounted to 40 per cent of total bank loans in 1994, is evidence of extensive misallocation of credit by the banks. Not all of these loans were to the public sector. The fact that these loans were not serviced suggests that they were not used to finance viable projects. Although some of these loans were disbursed before financial markets were liberalised, many date from the late 1980s or early 1990s, including those extended by the local banks, most of which only began operations during the liberalisation period.

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26 The exceptions were the maximum lending rates of merchant banks, which in 1993 were slightly higher than inflation, and the Interbank rate.

27 Data from CBN Annual Reports and IFS: real credit was derived by dividing nominal credit by the GDP deflator.

Mismanagement and fraud undermined the efficacy of liberalisation to improve resource allocation, not least because the prudential regulation of banks was deficient.

It is arguable that poor design and inappropriate sequencing of the reforms made a major contribution to the financial distress which emerged in the banking industry in the late 1980s and early 1990s, in three important respects. First, the prudential legislation was revised and supervisory capacities were strengthened only several years after the *de facto* liberalisation of bank licensing. Second, the reforms to the foreign exchange market, which introduced a managed auction, provided a strong incentive for private investors to set up banks, not to conduct conventional banking business but to obtain access to foreign exchange at preferential rates. Hence there were both opportunities and incentives for the rapid growth of banks which lacked the managerial resources to conduct prudent banking. Third, given the macroeconomic instability afflicting Nigeria, liberalisation of entry requirements and interest rates probably increased the risks of financial fragility for even well managed banks, in particular because it intensified competition for deposits and forced up nominal deposit and lending rates.

7 CONCLUSION

The banking system in Nigeria has experienced major changes since independence, many of which were shaped by government policies. At independence banking markets were dominated by a relatively small number of mainly foreign banks. In the following three and a half decades the number of banks expanded and the ownership structure diversified with first the public sector and then the Nigerian private sector becoming the dominant participants.

Beginning in the 1960s, the government intervened extensively in banking markets to control resource allocation and to promote the indigenisation of the economy. The policies pursued by the government were those of 'financial repression'. The CBN issued detailed guidelines to banks to control interest rates and the volume and direction of credit. The Federal Government acquired controlling equity stakes in all of the foreign banks during the 1970s while a number of banks were set up by the state governments. In the late 1970s the CBN initiated a rural banking programme under which the commercial banks were instructed to establish branches in the rural areas.

Financial repression and public sector ownership had significant consequences for banking markets. Competition was stifled, providing some degree of protection for inefficient banks, but the financial performance of the public sector banks was nevertheless poor. Policy lending - loans extended to the public sector or to priority sectors in accordance with credit guidelines - contributed to the build up of extensive non performing loans in the portfolios of the Federal Government and state government banks. Many of the state government banks were very badly managed and used for patronage and as a source of finance for their owners. State governments and other public sector agencies were among the major defaulters of the public sector banks.

The larger Federal Government banks were able to avoid serious financial difficulties, despite their bad debts and high overheads. They retained experienced management, the cost of their deposit base was low and their size enabled them to be well diversified. But extensive bad debts rendered some of the smaller Federal Government banks and many of the state government banks insolvent. Their financial fragility was concealed by a combination of public subsidy and improper accounting until the late 1980s. Since then stricter prudential standards and a less accommodating stance towards liquidity support by the authorities have exposed the widespread distress among these banks. Financial liberalisation began in 1986/87 after the government had adopted a SAP. The deregulation of banking markets was partial and, especially with regard to interest rates, inconsistent. Entry requirements (in terms of the granting of banking licenses) were relaxed in the mid 1980s and this facilitated a dramatic expansion in the number of commercial and merchant banks owned by the Nigerian private sector. Some of these banks have attracted a significant share of banking markets and have brought benefits for customers in terms of greater competition and improved services, albeit mainly confined to urban areas. In contrast many others were set up largely to take advantage of arbitrage opportunities in foreign exchange markets rather than to undertake more conventional banking business. Bad management and fraud, including insider lending, has been endemic among these banks and has led to widespread distress.

The introduction of more liberal economic policies in the second half of the 1980s, together with the emergence of extensive bank distress, necessitated reform to the system of prudential regulation and supervision. The deficiencies of the prudential system had included a lack of political independence for the supervisors, inadequate banking legislation and the priority given to ensuring that banks complied with allocative rather than prudential regulations. Banking legislation was strengthened in 1990 and 1991, with the CBN given greater powers to enforce compliance with the banking laws and to intervene in distressed banks. In addition the NDIC was set up in 1988 to insure bank deposits and to assist the CBN to restructure or liquidate distressed banks.

The reforms to the financial system implemented since the mid 1980s - liberalisation and privatisation, strengthening the prudential system and the take-over of some of the distressed banks - are an important step towards reshaping banking markets in the direction of efficiency, competition and prudent management. Nevertheless the banking system in

Nigeria is still a long way from attaining these objectives. Effective reform of the banking system faces a number of obstacles. The implementation of the reforms has been problematic: there is strong domestic opposition to the dismantling of controls over financial markets, as evidenced by the reimposition of lending rate ceilings. The efficacy of liberalisation has also been undermined by the scale of bank distress, which is partly a legacy of pre-reform policies of public ownership and inadequate prudential supervision but also partly the consequence of inappropriate sequencing of reforms.

The inconsistency of deregulation has been a serious drawback in the implementation of financial sector reforms. Some allocative controls, such as the credit guidelines, have not been removed, while lending rate ceilings have been removed twice and reimposed twice. Nine of the Federal Government banks were privatised in 1992/93 but the Government's commitment to a private sector led banking system is in doubt following its threat to retake control of the four largest banks, while four smaller Federal Government banks and the state government banks have not been divested. There are clearly political constraints on the degree to which government is prepared to disengage from banking markets and confine its role to that of prudential regulation.

The second deficiency in the implementation of reforms relates to their sequencing. Entry into banking markets was liberalised several years before banking legislation had been upgraded and supervisory capacities strengthened. Consequently a large number of local banks were set up whose owners and managers lacked the necessary competence or probity to compete in banking markets. Their main source of earnings was itself a product of the inconsistency of the reform process which allowed large differentials to prevail between official and parallel foreign exchange markets. The distress afflicting many of the local banks threatens widespread repercussions, not only in terms of the costs of reimbursing depositors, but also because it may undermine depositor confidence in some of the well managed local banks which have an important contribution to make to the development of banking markets.

A major impediment to the efficacy of financial reforms was the failure to maintain macroeconomic stability because of the large budget deficits accumulated by the Federal Government and financed mainly by the CBN. Deficit financing crowded out private sector borrowers from credit markets while its inflationary impact has impeded efforts to attain positive real deposit and lending rates. Macroeconomic instability also exacerbated the distress in the banking system by jeopardising the viability of banks' borrowers in the real sector and hence their ability to service their loans.

The reform process faces a number of challenges if a market oriented and soundly managed banking system is to develop in Nigeria. The most pressing challenge will be to deal with bank distress. There is however a core of solvent banks in Nigeria - the large formerly

Federal Government banks plus some of the state government and local banks - on which a market oriented banking system can be built. What is required is a much more comprehensive and consistent deregulation of controls over financial markets, a significant reduction in deficit financing and inflation and very tight prudential regulation. As with much else in Nigeria the major obstacles are likely to be political.

Table 1

Assets of the Main Financial Institutions 1980-1993
(millions of Naira: constant 1990 prices)

Type of Institution	1980		1993	
CBN	40860	(33.1)	113029	(46.4)
Commercial Banks	71358	(57.7)	88457	(36.4)
Merchant Banks	4402	(3.6)	21844	(8.9)
DFIs	2865	(2.3)	4220	(1.7)
Insurance Companies	1266	(1.0)	4850	(1.9)
Hire Purchase/Finance Companies	-		4725	(1.9)
Other	2873	(2.3)	5605	(2.8)
Total	123624	(100.0)	242730	(100.0)

The percentage distribution of the total assets are in parentheses.

Sources: Ojo (1994b: 256); IFS.

Table 2

Number and Ownership Structure of Commercial Banks: 1960-1992

Year	State Govt	FGN	FGN/ Foreign	Foreign	Private/ Foreign	Private	Miscellaneous	Total
1960	1			7		3	1	12
1970	6			7			2	15
1980	10		7		2	1		20
1985	14		7		5	2		28
1992	25	2	6		7	26		66

Key:
- State government: these are banks in which state governments (or regional governments in 1960) held majority or minority equity stakes.
- FGN: banks in which the Federal Government held equity stakes without foreign partnership, i.e. either as sole shareholder or in partnership with Nigerian private investors.
- FGN/Foreign: joint ventures between foreign investors and the Federal Government: Nigerian private investors held minority stakes in some of these banks.
- Foreign: banks with majority foreign share holdings.
- Private/Foreign: banks in which Nigerian private investors held majority stakes and foreign investors minority stakes.
- Private: banks wholly owned by Nigerian private investors.

Sources: Miscellaneous.

Table 3

Number and Ownership Structure of Merchant Banks: 1960-1992

Year	FGN	FGN/ Foreign	Foreign	Foreign/ Private	Private	Miscellaneous	Total
1960			2				2
1970			1				1
1980	2	3		1			6
1985	2	3		5	2		12
1992	2	3		7	41	1*	54

* This is a bank with state government participation

Key:
- FGN: banks in which the Federal Government held equity stakes without foreign partnership, i.e. either as sole shareholder or in partnership with Nigerian private investors.
- FGN/Foreign: joint ventures between foreign investors and the Federal Government: Nigerian private investors held minority stakes in some of these banks.
- Foreign: banks with majority foreign share holdings.
- Private/Foreign: banks in which Nigerian private investors held majority stakes and foreign investors minority stakes.
- Private: banks wholly owned by Nigerian private investors.

Sources: Miscellaneous.

Table 4

Selected Commercial Bank Interest Rates and Inflation: 1968-94
(% per annum)

Year	Inflation	3 Month Deposit Rate		Lending Rate	
		nominal	real	nominal	real
1968	-1.2	3.50	4.8	10.0	11.3
1969	11.0	3.00	-7.2	10.0	-0.9
1970	13.2	3.00	-9.0	10.0	-2.8
1971	16.5	3.00	-11.6	8.0	-7.3
1972	3.3	3.00	-0.3	10.0	6.5
1973	4.8	3.00	-1.7	10.0	5.0
1974	13.1	3.00	-8.9	10.0	-2.7
1975	34.0	3.00	-23.1	9.0	-18.7
1976	23.9	2.50	-17.3	10.0	-11.2
1977	13.9	3.00	-9.6	6.0	-6.9
1978	21.9	4.75	-14.1	11.0	-8.9
1979	11.5	5.50	-5.4	11.0	-0.5
1980	10.1	5.70	-4.0	9.5	-0.5
1981	20.9	5.75	-12.5	10.0	-9.0
1982	7.6	7.50	-0.1	11.4	3.5
1983	23.3	7.25	-13.0	11.5	-9.5
1984	39.6	9.25	-21.7	13.0	-19.1
1985	7.4	9.25	1.7	11.75	4.1
1986	5.7	9.75	3.8	12.0	6.0
1987	11.4	14.90	3.1	19.0	6.8
1988	54.5	13.00	-26.9	17.0	-24.3
1989	50.4	20.50	-19.9	25.7	-16.4
1990	7.4	19.80	11.6	26.5	17.8
1991	13.0	15.20	2.0	21.0	7.1
1992	44.6	20.80	-16.5	31.2	-9.3
1993	57.0	23.60	-21.3	39.1	-11.4
1994	70.0	13.40	-33.3	21.0	-28.8

The lending rate up to 1989 is that specified for ’other advances’ by the CBN, i.e. non preferred sectors. From 1990 onwards it is the maximum lending rate. Real rates are pre-tax.

Sources: Central Bank of Nigeria Annual Reports and Economic and Financial Reviews, various issues, IFS.

Table 5

Minimum Paid-Up Capital Requirements for Banks in Nigeria
(thousands of Naira and US$ equivalents)

Period	Type of Bank	Naira (000)	US$ (000) Equivalent
1969-79	Indigenous Commercial	600	840-993
	Expatriate Commercial	1500	2101-2483
	Merchant	2000	3175-3311
1979-88	Commercial	1500	2483-331
	Merchant	2000	3311-441
1988-89	Commercial	10000	2204-1358
	Merchant	6000	1377-815
1989-91	Commercial	20000	2716-2018
	Merchant	12000	1629-1211
1991-	Commercial	50000	5046-610*
	Merchant	40000	4037-488*

The two US dollar figures given for each period reflect the dollar equivalent of the Naira value in the first and last year of the period.

* Figures refer to 1995.

The distinction between expatriate and indigenous banks was removed following the indigenisation decrees in the mid 1970s. The minimum paid up capital for merchant banks was first introduced in the early 1970s.

Sources: Ogunleye (1991); Nwankwo (1980: 52).

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